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COMMUNITY BANCSHARES INC /DE/  
Form 10-Q  
May 15, 2003

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C. 20549

Form 10-Q

☒ QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934  
For the quarterly period ended March 31, 2003  
OR

☐ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE  
SECURITIES EXCHANGE ACT OF 1934

Commission File No. 000-16461

COMMUNITY BANCSHARES, INC.  
(Exact name of registrant as specified in its charter)

Delaware 63-0868361  
(State or other jurisdiction of (I.R.S. Employer Identification No.)  
incorporation or organization)

68149 Main Street  
Blountsville, Alabama 35031  
(Address of principal executive offices)

(205) 429-1000  
(Registrant's telephone number)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days:

☒ yes ☐ no

Indicate by check mark whether the registrant is an accelerated filer (as defined in Exchange Act rule 12b-2):

☐ yes ☒ no

As of May 1, 2003, there were 4,643,740 shares of the registrant's common stock, \$.10 par value shares, outstanding.

FORM 10-Q  
COMMUNITY BANCSHARES, INC.  
MARCH 31, 2003

Table of Contents

Part 1 - Financial Information

# Edgar Filing: COMMUNITY BANCSHARES INC /DE/ - Form 10-Q

Item 1 -	Consolidated Statements Financial Statements (Unaudited)
	Consolidated Statements of Condition as of March 31, 2003 and December 31, 2002.....
	Consolidated Statements of Income for the Three Months Ended March 31, 2003 and 2002.....
	Consolidated Statements of Cash Flows for the Three Months Ended March 31, 2003 and 2002.....
	Notes to Consolidated Financial Statements.....
Item 2 -	Management's Discussion and Analysis of Financial Condition and Results of Operations.....
Item 3 -	Quantitative and Qualitative Disclosures About Market Risk.....
Item 4 -	Controls and Procedures.....
Part 2 -	Other Information
Item 1 -	Legal Proceedings.....
Item 6 -	Exhibits and Reports on Form 8-K.....
Signatures	
Certifications of Periodic Financial Reports	

2

## PART 1 Item 1 - Financial Statements

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CONDITION (UNAUDITED)

	March 31, 2003
	-----
Assets	
Cash and due from banks.....	\$ 33,121,261
Interest-bearing deposits in banks and federal funds sold.....	21,625,000
Securities available for sale .....	122,766,974
Loans (net of unearned income) .....	346,639,392
Allowance for possible loan losses .....	(10,123,476)
	-----
Net loans .....	336,515,916
Capitalized lease receivable.....	3,030,327
Premises and equipment, net .....	24,964,572
Accrued interest receivable.....	3,822,672
Goodwill and other intangible assets, net.....	2,693,535
Other real estate owned .....	8,503,423
Other assets .....	9,199,001
	-----
Total Assets.....	\$ 566,242,681

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## Liabilities And Shareholders' Equity

### Deposits:

Noninterest-bearing.....	\$ 56,866,739
Interest-bearing.....	404,876,854

Total deposits .....	461,743,593
Other short-term borrowings .....	201,556
Accrued interest payable.....	3,837,386
FHLB long-term debt.....	38,000,000
Capitalized lease obligations .....	4,037,887
Other long-term debt .....	3,477,457
Trust preferred securities .....	10,000,000
Other liabilities .....	5,822,863

Total liabilities .....	527,120,742
-------------------------	-------------

### Shareholders' equity

Preferred stock (par value \$.01 per share, 200,000 shares authorized, no shares issued).....	-
Common stock (par value \$.10 per share, 20,000,000 shares authorized, 4,810,089 shares issued as of March 31, 2003 and December 31, 2002).....	481,009
Additional paid in capital.....	30,787,584
Retained earnings .....	10,474,852
Treasury stock (23,803 shares as of March 31, 2003 and December 31, 2002).....	(441,768)
Unearned ESOP shares (142,546 and 148,972 shares as of March 31, 2003 and December 31, 2002, respectively).....	(1,935,598)
Accumulated other comprehensive income (loss), net of taxes .....	(244,140)

Total shareholders' equity .....	39,121,939
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Total Liabilities and Shareholders' Equity	\$ 566,242,681
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See accompanying notes to consolidated financial statements

3

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME (UNAUDITED)

For the Three Months  
2003

### Interest Income

Interest and fees on loans.....	\$ 7,360,905
Interest on investment securities:	
Taxable securities.....	1,374,647
Non taxable securities.....	89,325
Interest on federal funds sold.....	82,258
Other interest.....	7,110

Total interest income .....	8,914,245
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### Interest Expense

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Interest on deposits .....	2,885,208
Interest on short-term borrowings .....	1,150
FHLB long-term debt.....	563,350
Interest on capitalized lease obligations.....	42,452
Interest on trust preferred securities.....	314,164
Interest on other long-term debt.....	30,471
	-----
Total interest expense.....	3,836,795
	-----
Net interest income.....	5,077,450
Provision for loan losses .....	1,289,439
	-----
Net interest income after provision for loan losses.....	3,788,011
Noninterest Income	
Service charges on deposits .....	610,558
Insurance commissions. ....	563,793
Bank club dues .....	106,559
Debt cancellation fees .....	30,115
Other operating income .....	225,537
Securities gains, net.....	647,641
	-----
Total noninterest income.....	2,184,203
	-----
Noninterest Expense	
Salaries and employee benefits .....	3,328,797
Occupancy expense .....	589,005
Furniture and equipment expense.....	367,391
Director and committee fees .....	122,200
Net loss on sale or write-down of other	
real estate owned.....	252,728
Net loss on disposal of assets.....	-
Other operating expenses .....	2,348,682
	-----
Total noninterest expense.....	7,008,803
	-----
INCOME (Loss) from continuing operations	
BEFORE INCOME TAXES.....	(1,036,589)
Applicable income taxes.....	487,480
	-----
INCOME (Loss) from continuing operations.....	(549,109)
	-----

See accompanying notes to consolidated financial statements

4

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF INCOME - CONTINUED (UNAUDITED)

For the Three Months  
2003

### Discontinued Operations:

Income from operations of divested branches	
(includes gain on disposal of \$1,551,443).....	-
Applicable income taxes.....	-
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Net Income (Loss).....	\$	(549,109)	=====
OTHER COMPREHENSIVE INCOME:			
Unrealized holding gains (losses) arising during period, net of income taxes of \$197,536 and \$243,748, respectively.....	\$	(296,305)	
Reclassification adjustment related to net realized gains, net of income taxes of \$259,056 and \$6,658, respectively.....		(388,585)	-----
Other Comprehensive Income (LOSS).....		(684,890)	-----
COMPREHENSIVE INCOME (LOSS).....	\$	(1,233,999)	=====
Earnings (loss) per common share - income (loss) from continuing operations:			
Basic.....	\$	(0.12)	
Diluted.....	\$	(0.12)	
Earnings (loss) per common share - net income (loss):			
Basic.....	\$	(0.12)	
Diluted.....	\$	(0.12)	
Average number of shares outstanding:			
Basic.....		4,640,527	
Diluted.....		4,640,527	
Dividends per share.....	\$	-	\$

See accompanying notes to consolidated financial statements

5

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS (UNAUDITED)

	For the Three Months	
	2003	
-----		
Cash Flows From Operating Activities		
Net income (loss).....	\$	(549,109)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:		
Provision for loan losses .....		1,289,439
Provision for depreciation and amortization .....		444,682
Amortization of investment security premiums and accretion of discounts.....		169,484
Deferred tax expense.....		98,168
Realized investment security gains. ....		(647,641)
Gain on sale of branches.....		-
Loss on sale of premises and equipment .....		-
Net loss or write-down on other real estate owned.....		252,728
Decrease in accrued interest receivable.....		547,076
Increase in accrued interest payable.....		214,621
Other .....		1,048,936
		-----

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Net cash provided by operating activities.....	2,868,384
	-----
Cash Flows From Investing Activities	
Proceeds from sales, calls and pay downs of securities	
available for sale.....	61,700,976
Proceeds from maturity of securities	
available for sale.....	15,000,000
Purchase of securities available for sale.....	(76,229,805)
Cash disbursed in settlement of branch divestitures.....	-
Net decrease in loans to customers.....	10,602,672
Proceeds from sale of premises and equipment.....	-
Capital expenditures.....	(93,909)
Net proceeds from sale of other real estate.....	55,630
	-----
Net cash provided by investing activities.....	11,035,564
	-----
Cash Flows From Financing Activities	
Net increase in demand deposits,	
NOW accounts, savings and time open deposit accounts.....	7,248,363
Net decrease in certificates of deposit .....	(4,968,574)
Net (decrease) increase in short-term borrowings .....	(1,523,577)
Net decrease in capitalized lease obligations .....	(20,282)
Repayment of long-term debt.....	(100,230)
	-----
Net cash provided by (used in) financing activities .....	635,700
	-----
NET INCREASE IN CASH AND CASH EQUIVALENTS.....	14,539,648
CASH AND CASH EQUIVALENTS, BEGINNING OF PERIOD.....	40,206,613
	-----
CASH AND CASH EQUIVALENTS, END OF PERIOD.....	\$ 54,746,261
	=====

See accompanying notes to consolidated financial statements

6

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES CONSOLIDATED STATEMENTS OF CASH FLOWS - CONTINUED (UNAUDITED)

	For the Three Months
	-----
	2003
	-----
Supplemental cash flow disclosures:	
Cash paid for:	
Interest.....	\$ 3,622,174
Income taxes.....	-
schedule of non-cash investing and	
financing activities:	
Foreclosure of other real estate owned.....	1,256,642
Loan charge-offs, net of recoveries.....	950,232

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See accompanying notes to consolidated financial statements

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7

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

#### NOTE 1 - GENERAL

The consolidated financial statements include the accounts of Community Bancshares, Inc. and its wholly-owned subsidiaries, collectively, hereinafter referred to as the "Company". The accompanying unaudited consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, they do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation have been included. Operating results for the three month period ending March 31, 2003 are not necessarily indicative of the results that may be expected for the year ending December 31, 2003. For further information, refer to the consolidated financial statements and footnotes thereto included in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

Certain reclassifications of prior years' amounts have been made to conform to current year presentation. These reclassifications had no effect on net income, total assets, total liabilities, or shareholders' equity.

The Company's significant accounting policies are presented in Note 1 to the consolidated financial statements in the Company's Annual Report on Form 10-K for the year ended December 31, 2002. These policies, along with the disclosures presented in the other footnotes, provide information on how significant assets and liabilities are valued in the financial statements and how those values are determined. Those accounting policies involving significant estimates and assumptions by management, which have, or could have, a material impact on the carrying value of certain assets and impact comprehensive income, are considered critical accounting policies. The Company recognizes the following as critical accounting policies: Accounting for Allowance for Loan Losses and Accounting for Income Taxes.

**Accounting for Allowance for Loan Losses.** Management's ongoing evaluation of the adequacy and allocation of the allowance considers both impaired and unimpaired loans and takes into consideration the Company's past loan loss experience, known and inherent risks in the portfolio, adverse situations that may affect the borrowers' ability to repay, estimated value of any underlying collateral, the reviews of regulators, and an analysis of current economic conditions. While management believes that it has exercised prudent judgment and applied reasonable assumptions which have resulted in an allowance presented in accordance with generally accepted accounting principles, there can be no assurance that in the future, adverse economic conditions, increased nonperforming loans, regulatory concerns, or other factors will not require further increases in, or reallocation of the allowance.

**Accounting for Income Taxes.** The Company uses the asset and liability method of accounting for income taxes. Determination of the deferred and current provision requires analysis by management of certain transactions and the related tax laws

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and regulations. Management exercises significant judgment in evaluating the amount and timing of recognition of the resulting tax liabilities and assets. Those judgments and estimates are re-evaluated on a continual basis as regulatory and business factors change.

### NOTE 2 - CAPITAL SECURITIES

In March 2000, the Company formed a wholly-owned Delaware statutory business trust, Community (AL) Capital Trust I (the "Trust"), which issued \$10,000,000 of guaranteed preferred securities representing undivided beneficial interests in the assets of the Trust ("Capital Securities"). All of the common securities of the Trust are owned by the Company. The proceeds from the issuance of the Capital Securities (\$10,000,000) and common securities (\$310,000) were used by the Trust to purchase \$10,310,000 of junior subordinated deferrable interest debentures of the Company which carry an annual interest rate of 10.875%. Under the terms of the indenture, the Company may elect to defer payments of interest for up to ten semiannual payment periods. The Company has elected to defer its March 2002, September 2002 and March 2003 interest payments and may elect to do so again based on the

8

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

liquidity needs of the Company when future payments become due. For the duration of such deferral period, the Company is restricted from paying dividends to shareholders or paying debt that is junior to the debenture. The debentures represent the sole asset of the Trust. The debentures and related income statement effects are eliminated in the Company's consolidated financial statements. The Company is entitled to treat the aggregate liquidation amount of the debentures as Tier I capital under Federal Reserve guidelines.

The Capital Securities accrue and pay distributions semiannually at a rate of 10.875% per annum of the stated liquidation value of \$1,000 per capital security. The Company has entered into an agreement which fully and unconditionally guarantees payment of: (i) accrued and unpaid distributions required to be paid on the Capital Securities; (ii) the redemption price with respect to any Capital Securities called for redemption by the Trust; and (iii) payments due upon a voluntary or involuntary liquidation, winding up or termination of the Trust.

The Capital Securities are mandatorily redeemable upon the maturity of the debentures on March 8, 2030, or upon earlier redemption as provided in the indenture pursuant to which the debentures were issued. The Company has the right to redeem the debentures purchased by the Trust: (i) in whole or in part, on or after March 8, 2010; and (ii) in whole (but not in part) at any time within 90 days following the occurrence and during the continuation of a tax event, capital treatment event or investment company event (each as defined in the indenture). As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be a percentage of the principal amount, ranging from 105.438% in 2010 to 100.00% in and after 2020, plus accrued but unpaid interest.

### NOTE 3 - SEGMENT REPORTING

All of the Company's offices offer similar products and services, are located in the same geographic region and serve the same customer segments of the market. As a result, management considers all units as one operating segment and therefore believes that the basic financial statements and related footnotes



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provide sufficient detail related to segment reporting.

## NOTE 4 - STOCK BASED COMPENSATION

SFAS No. 123, "Accounting for Stock-Based Compensation," defines a fair value based method of accounting for an employee stock option or similar equity instrument. However, SFAS No. 123 allows an entity to continue to measure compensation costs for those plans using the intrinsic value based method of accounting prescribed by APB Opinion No. 25, Accounting for Stock issued to Employees. Entities electing to remain with the accounting in Opinion No. 25 must make pro forma disclosures of net income and earnings per share as if the fair value based method of accounting defined in SFAS No. 123 had been applied. Under the fair value based method, compensation cost is measured at the grant date based on the value of the award and is recognized over the service period, which is usually the vesting period. Under the intrinsic value based method, compensation cost is the excess, if any, of the quoted market price of the stock at the grant date or other measurement date over the amount an employee must pay to acquire the stock. The Company has elected to continue to measure compensation cost for its stock option plans under the provisions in APB Opinion 25 and has calculated the fair value of outstanding options for purposes of pro forma disclosure utilizing the Black-Scholes method.

The Black-Scholes option valuation model was developed for use in estimating the fair value of traded options that have no vesting restrictions and are fully transferable. In addition, option valuation models require the input of highly subjective assumptions including the expected stock price volatility. Because the Company's employee stock options have characteristics significantly different from those of traded options, and because changes in the subjective input assumptions can materially affect the fair value estimate, the existing models do not necessarily provide a reliable single measure of the fair value of its employee stock options.

The Company's options granted during the first three months of 2003 vest immediately; therefore, for purposes of pro forma disclosure, the compensation expense related to these options has been recognized when granted. No options were granted during the first three months of 2002.

9

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

The Company's actual pro forma information follows:

	For the Three Months E
	2003
Net income (loss):	
As reported	\$ (549,109)
Deducts:	
Total stock-based employee compensation expense determined under fair value based method for all awards, net of tax	139,590
Pro forma net income (loss)	\$ (688,699)

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Basic earnings (loss) per share:	
As reported	(0.12)
Pro forma	(0.15)
Diluted earnings (loss) per share:	
As reported	(0.12)
Pro forma	(0.15)

The fair value of each option grant is estimated on the date of the grant using the Black-Scholes option-pricing model with the following weighted-average assumptions used for the options granted in 2003: dividend yield 0%; expected volatility of .283; risk-free interest rates of 3.10%; and expected lives of 5 years.

### NOTE 5 - CONTINGENCIES

#### Background

At a meeting of Community Bank's Board of Directors on June 20, 2000, a director brought to the attention of the Board the total amount of money Community Bank had paid subcontractors in connection with the construction of a new Community Bank office in Guntersville, Alabama. Management of the Company commenced an investigation of the expenditures. At the request of management, the architects and subcontractors involved in the construction project made presentations to the Boards of Directors of the Company and Community Bank on July 15 and July 18, 2000, respectively. At the July 18, 2000 meeting of the Board of Directors of Community Bank, another director alleged that Community Bank had been overcharged by subcontractors on that construction project and another current construction project. On July 18, 2000, the Boards of Directors of the Company and Community Bank appointed a joint committee comprised of independent directors of the Company and of Community Bank to investigate the alleged overcharges. The joint committee retained independent legal counsel and an independent accounting firm to assist the committee in its investigation and has made its report to the Boards of Directors. The directors of Community Bank who alleged the construction overcharges have made similar charges to bank regulatory agencies and law enforcement authorities. Management believes that these agencies and authorities are currently conducting investigations regarding this matter.

#### Benson Litigation

On July 21, 2000, three shareholders of the Company, M. Lewis Benson, Doris E. Benson and John M. Packard, Jr., filed a lawsuit in the state Circuit Court of Marshall County, Alabama against the Company, Community Bank, certain directors and officers of the Company and Community Bank, an employee of Community Bank and two construction subcontractors. The plaintiffs purported to file the lawsuit as a shareholder derivative action, which relates to the alleged

COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO  
CONSOLIDATED FINANCIAL STATEMENTS  
(UNAUDITED)

construction overcharges being investigated by the joint committee of the Boards of Directors of the Company and Community Bank. The complaint alleges that the directors, officers and employee named as defendants in the complaint breached their fiduciary duties, failed to properly supervise officers and agents of the Company and Community Bank, and permitted waste of corporate assets by allegedly permitting the subcontractor defendants to overcharge Community Bank in connection with the construction of two new Community Bank offices, and to

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perform the construction work without written contracts, budgets, performance guarantees and assurances of indemnification. In addition, the complaint alleges that Kennon R. Patterson, Sr., the Chairman, President and Chief Executive Officer of the Company, breached his fiduciary duties by allegedly permitting the two named subcontractors to overcharge for work performed on the two construction projects in exchange for allegedly discounted charges for work these subcontractors performed in connection with the construction of Mr. Patterson's residence. The complaint further alleges that the director defendants knew or should have known of this alleged arrangement between Mr. Patterson and the subcontractors. The complaint also alleges that Mr. Patterson, the Community Bank employee and the two subcontractor defendants made false representations and suppressed information about the alleged overcharges and arrangement between Mr. Patterson and the subcontractors.

On August 15, 2000, the plaintiffs filed an amended complaint adding Andy C. Mann, a shareholder of the Company, as a plaintiff and adding a former director of the Company and Community Bank as a defendant. The amended complaint generally reiterates the allegations of the original complaint. In addition, the amended complaint alleges that Community Bank was overcharged on all construction projects from January 1997 to the present. The amended complaint also alleges that the defendants breached their fiduciary duties and are guilty of gross financial mismanagement, including allegations concerning the making or approval of certain loans and taking allegedly improper actions to conceal the fact that certain loans were uncollectible. On September 18, 2000 the plaintiffs filed a second amended complaint. The second amended complaint generally reiterates the allegations of the original and first amended complaints. In addition, the second amended complaint alleges that the plaintiffs were improperly denied their rights to inspect and copy certain records of the Company and Community Bank. The second amended complaint also alleges that the directors of the Company abdicated their roles as directors either by express agreement or as a result of wantonness and gross negligence. The second amended complaint asserts that the counts involving inspection of corporate records and director abdication are individual, non-derivative claims. The second amended complaint seeks, on behalf of the Company, an unspecified amount of compensatory damages in excess of \$1 million, punitive damages, disgorgement of allegedly improperly paid profits and appropriate equitable relief. Upon motion of the defendants, the case was transferred to the state Circuit Court in Blount County, Alabama by order dated September 21, 2000, as amended on October 12, 2000.

On August 24, 2000, the Board of Directors of the Company designated the directors of the Company who serve on the joint investigative committee as a special litigation committee to investigate and evaluate the allegations and issues raised in this lawsuit and to arrive at such decisions and take such action as the special litigation committee deems appropriate. On June 8, 2001, the special litigation committee filed its report under seal with the court. On June 18, 2001, the court entered an order affirming the confidentiality of the special committee's report. On June 28, 2001, the Company, Community Bank and various other defendants filed a motion with the court to adopt the report of the special committee, for partial summary judgment and to realign the Company and Community Bank as plaintiffs in the lawsuit.

Following a hearing on August 29, 2001, the court denied these motions on November 8, 2001. The court also ruled that the plaintiffs were entitled to conduct discovery except as it related to one of the subcontractor defendants and granted the plaintiffs' motion to unseal the report of the special litigation committee. On November 14, 2001, the directors of the Company filed a motion for the court to alter, amend, or vacate its November 8, 2001 rulings. On February 7, 2002, the Company and Community Bank filed a motion to disqualify Maynard, Cooper & Gale, P.C., the law firm representing the plaintiffs, due to conflicts of interest. The court held a hearing on these motions on February 22, 2002 and the parties are awaiting a ruling. A tentative settlement of the

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lawsuit was announced in November, 2002, but was not finalized. On or about April 21, 2003 the plaintiffs filed a motion to enforce the tentative settlement. One of the subcontractors named as a defendant in this action, Morgan City Construction, Inc., and its principals, Mr. and

11

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

Mrs. Dewey Hamaker, have been tried and convicted in the United States District Court for the Northern District of Alabama.

Because of the inherent uncertainties of the litigation process, the Company is unable at this time to predict the outcome of this lawsuit and its effect on the Company's financial condition and results of operations.

#### Packard Derivative Litigation

On April 4, 2003, a group composed of the same plaintiffs as in the Benson case filed another derivative action against Sheffield Electrical Contractors, Inc., Steve Sheffield, Jay Bolden, Dudley, Hopton-Jones, Sims & Freeman, PLLP, Glynn Debter, Kennon R. Patterson, Jr., Robert O. Summerford, Jimmie Trotter, John Lewis, Jr., Merritt Robbins, Stacy Mann, B. K. Walker, Jr., Denny Kelly, Roy B. Jackson, Loy McGruder, and Hodge Patterson. The complaint in this new derivative lawsuit, besides adding defendants known during but not named in the Benson lawsuit, is based upon the same allegations as in the Benson case but bases its claims against the director-defendants not "for what they did (and did not do) before learning of the over billing [sic.] allegations against Patterson [Kennon R. Patterson, Sr., the Company's former Chairman and CEO] in July 2000" but, instead "only for what they have done (and failed to do) after the filing of the Benson lawsuit-- that is, after they learned of the allegations against Patterson in July 2000." [Emphasis in the original.] On May 8, 2003 the Company, Community Bank and most of the individual defendants filed a motion to transfer the suit to the Circuit Court of Blount County, Alabama, or, in the alternative, to dismiss the suit.

Because of the inherent uncertainties of the litigation process, the Company is unable at this time to predict the outcome of this lawsuit and its effect on the Company's financial condition and results of operations.

#### Corr Family Litigation

On September 14, 2000, Bryan A. Corr and six other shareholders of the Company related to Mr. Corr filed an action in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, and certain directors and officers of the Company and Community Bank. The plaintiffs have alleged that the directors of the Company actively participated in or ratified the misappropriation of corporate income. The action was not styled as a shareholder derivative action. On January 3, 2001, the defendants filed a motion for summary judgment on the basis that these claims are derivative in nature and cannot be brought on behalf of individual shareholders. The court has not ruled on the motion. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming, and a diversion of management's attention.

12

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

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(UNAUDITED)

### Lending Acts Litigation

On October 11, 2002, William Alston, Murphy Howard, and Jason Tittle filed an action against Community Bank, Community Bancshares, Inc., Holsombeck Motors, Inc., Lee Brown d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Chris Holmes d/b/a Alabama Bond & Investigation a/k/a ABI Recovery, Regina Holsombeck, Kennon "Ken" Patterson, Sr., Hodge Patterson, James Timothy "Tim" Hodge, Ernie Stephens, and the State of Alabama Department of Revenue. The plaintiffs in this class action allege that Community Bank and others conspired or used extortionate methods to effect a lending scheme of "churning phantom loans", and that profits from the scheme were used to secure an interest in and/or to invest in an enterprise that affects interstate commerce. The allegations state that Community Bank used various methods to get uneducated customers with fair to poor credit to sign numerous "phantom loans" when the customers only intended to sign for one loan. Claims include racketeering activity within the meaning of the Racketeer Influenced and Corrupt Organizations Act of 1970, conspiracy, spoliation, conversion, negligence, wantonness, outrage, and civil conspiracy.

The Company and Community Bank intend to defend the action vigorously and currently are conducting discovery to ascertain what substance, if any, there is to the claims. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming, and a diversion of management's attention.

### Patterson Litigation

On April 9, 2003 Kennon R. Patterson, Sr., former Chairman, President and Chief Executive Officer of the Company, filed an adversary proceeding in the United States Bankruptcy Court for the Northern District of Alabama in connection with his petition for protection under Chapter 11 of the United States Bankruptcy Code. Defendants of the adversary proceeding are the Company, Community Bank, five directors of the Company and Community Bank and the law firm of Powell, Goldstein, Frazer and Murphy, LLP which represents Community Bank's Audit Committee. The complaint alleges that the Company breached its employment agreement with Mr. Patterson by terminating his employment on January 27, 2003 and failed to pay him for compensation and benefits which had allegedly accrued prior to his termination. The complaint also alleges that Community Bank, members of Community Bank's Audit Committee, the Audit Committee's independent counsel and the Company's current Chairman, President and Chief Executive Officer conspired to interfere with Mr. Patterson's contract and business relationship with the Company. The suit seeks damages in excess of \$150 million for, among other things, lost compensation and benefits, mental anguish, and damage to Mr. Patterson's reputation. The Company believes that this lawsuit is without merit and intends to defend the action vigorously. On May 9, 2003 the defendants filed a motion to dismiss the suit. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

### Employee Litigation

On May 5, 2003 two former executive officers of the Company and Community Bank filed separate suits in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and a number of fictitious defendants. Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of the Company, and Denny G. Kelly, former President of Community Bank, allege that they were induced to retire based on

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misrepresentations made by Kennon R. Patterson, Sr. who was allegedly acting within the scope of his duties as an agent of the Company and Community Bank. Plaintiffs claim that these actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints ask for an unspecified amount of compensatory and punitive damages. Although

13

### COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

#### General

The Company and its subsidiaries are from time to time also parties to other legal proceedings arising in the ordinary course of business. Management believes, after consultation with legal counsel, that no such proceedings, if resulting in an outcome unfavorable to the Company, will, individually or in the aggregate, have a material adverse effect on the Company's financial condition or results of operations.

The Company's Certificate of Incorporation provides that, in certain circumstances, the Company will indemnify and advance expenses to its directors and officers for judgments, settlements and legal expenses incurred as a result of their service as officers and directors of the Company. Community Bank's Bylaws contain a similar provision for indemnification of directors and officers of Community Bank.

#### NOTE 6 - DISCONTINUED OPERATIONS

During 2002, Community Bank consummated the sale of the following branches: two Pulaski, Tennessee locations on March 31, 2002, two DeKalb County, Alabama locations on May 3, 2002, and six Marshall County, Alabama locations on May 31, 2002. Income and expenses related to these locations are included in discontinued operations for the three months ended March 31, 2002 for comparative purposes.

#### NOTE 7 - INTANGIBLE ASSETS

In June 2001, the FASB issued Statement No. 142, Goodwill and Other Intangible Assets. The statement requires that goodwill and other intangible assets with indefinite useful lives no longer be amortized, but instead an entity must perform an assessment of whether these assets are impaired as of the date of adoption and test for impairment at least annually in accordance with the provisions of the statement. The statement also required that intangible assets with determinable lives be amortized. The Company adopted Statement No. 142 on January 1, 2002.

Acquired goodwill and other intangible assets at March 31, 2003, are detailed as follows:

As of March 31, 2003

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	Gross Carrying Amount	Accumulated Amortization
Identifiable amortizing assets.....	\$ 2,173,861	\$ 1,273,13
Nonamortizing goodwill.....	2,851,372	1,058,56
Total acquired intangible asset.....	\$ 5,025,233	\$ 2,331,69

Aggregate amortization expense for the period ended March 31, 2003 was \$19,854. Aggregate amortization expense of \$79,417 is estimated for the years ending December 31, 2003 and 2004.

## Note 8 - Recently Issued Accounting Standards

In January 2003, the FASB issued FIN 46, which clarifies the application of Accounting Research Bulletin ("ARB") 51, Consolidated Financial Statements, to certain entities (called variable interest entities) in which equity investors do not have the characteristics of a controlling financial interest or do not have sufficient equity at risk for the entity to finance its

14

## COMMUNITY BANCSHARES, INC. AND SUBSIDIARIES-CONTINUED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (UNAUDITED)

activities without additional subordinated financial support from other parties. The disclosure requirements of this Interpretation are effective for all financial statements issued after January 31, 2003. The consolidation requirements apply to all variable interest entities created after January 31, 2003. In addition, public companies must apply the consolidation requirements to variable interest entities that existed prior to February 1, 2003 and remain in existence as of the beginning of annual or interim periods beginning after June 15, 2003. Management is currently assessing the impact of FIN 46, and does not expect this Interpretation to have a material impact to the Consolidated Financial Statements.

On April 30, 2003, the FASB issued SFAS No. 149, Amendment of Statement 133 on Derivative Instruments and Hedging Activities. SFAS No. 149 amends and clarifies financial accounting and reporting for derivative instruments, including certain derivative instruments embedded in other contracts and for hedging activities under SFAS No. 133, Accounting for Derivative Instruments and Hedging Activities. The provisions of SFAS No. 149 are effective for fiscal quarters beginning after June 15, 2003. Management does not believe the provisions of this standard will have a material impact on results of future operations.

15

## Item 2 - Management's Discussion and Analysis of Financial Condition and Results of Operations

This discussion is intended to assist in an understanding of the financial condition and results of operations of Community Bancshares, Inc. (the "Company") and its subsidiaries. Unless the context otherwise indicates, the Company shall include the Company and its subsidiaries. This analysis should be read in conjunction with the financial statements and related notes appearing in Item 1 of this Report and Management's Discussion and Analysis of Financial Condition

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and Results of Operations appearing in the Company's Annual Report on Form 10-K for the year ended December 31, 2002.

### Forward looking information

Certain statements in this Report are "forward-looking statements" within the meaning of Section 27A of the Securities Act of 1933, as amended, and Section 21E of the Securities Exchange Act of 1934, as amended. These forward-looking statements are not based on historical facts and may be identified by their reference to a future period or by the use of forward-looking terminology, such as "anticipate," "estimate," "expect," "may" and "should." These forward-looking statements include, without limitation, those relating to the Company's future growth and profitability, economic prospects of market areas, dividends, pending litigation, branch office divestitures, non-compliant or impaired loans, capital requirements, operating strategy, deposits, consumer base, allowance for loan losses, non-performing assets, interest rate sensitivity, market risk and impact of inflation. We caution you not to place undue reliance on these forward-looking statements. Actual results could differ materially from those indicated in such forward-looking statements due to a variety of factors. These factors include, but are not limited to, changes in economic conditions and government fiscal and monetary policies, changes in prevailing interest rates and effectiveness of the Company's interest rate strategies, laws, regulations and regulatory authorities affecting financial institutions, changes in and effectiveness of the Company's operating or expansion strategies, geographic concentration of the Company's assets and operations, competition from other financial services companies, unexpected financial results or outcomes of legal proceedings, and other risks detailed from time to time in the Company's press releases and filings with the Securities and Exchange Commission. We undertake no obligation to update these forward-looking statements to reflect events or circumstances occurring after the date of this Report.

### FINANCIAL CONDITION

March 31, 2003 compared to December 31, 2002

#### Summary

Total assets at March 31, 2003 were \$566,243,000, down from \$567,596,000 at December 31, 2002. Although total assets remained stable, the Company continued to experience declines in loans. As this occurred, asset balances shifted from loans to cash and due from banks.

#### Earning Assets

The earning assets of the Company are mainly composed of investment securities, federal funds sold and loans. Investment securities decreased \$1,134,000, or 0.9%, to \$122,767,000 at March 31, 2003 from \$123,901,000 at December 31, 2002. The investment securities portfolio is used to make various term investments, to provide a source of liquidity and to serve as collateral to secure certain government deposits. Short-term investments in the form of interest-bearing deposits with banks were \$260,000 at March 31, 2003 compared to \$200,000 at December 31, 2002. The Company had \$21,365,000 in federal funds sold at March 31, 2003, compared to \$24,030,000 at December 31, 2002, representing a decrease of \$2,665,000, or 11.1%.

Cash and due from banks increased \$17,145,000 during the first quarter of 2003. Earnings credit rates are applied to balances held in the Company's correspondent bank accounts held with other banks. The Company is given a credit based on its balance and the credit is used to offset service charges to the Company. These earnings credit rates are currently higher than the federal funds sold rates. The Company increased its balances in its main correspondent account during 2003 to take advantage of the better rate; therefore, earning a larger



credit against

16

service charges it would have paid than the interest income it otherwise would have received had the funds been in federal funds sold.

Loans comprise the largest single category of the Company's earning assets. Loans, net of unearned income, were \$346,639,000 at March 31, 2003 down \$12,545,000, or 3.5%, from \$359,184,000 at December 31, 2002. The Company continues to experience a decline in total loans because of economic downturns, the tightening of the Company's credit standards, and increased charge-offs of loans made in previous years.

#### Nonperforming Assets and Past Due Loans

Between December 31, 2002 and March 31, 2003, the ratio of the allowance for loan losses to total nonperforming assets (defined as nonaccruing loans, loans past due 90 days or greater, restructured loans, nonaccruing securities, and other real estate) declined from 43.95% at year-end 2002 to 34.98% at March 31, 2003. The ratio of total nonperforming assets to total assets increased to 5.11% at March 31, 2003 from 3.92% at year-end 2002, while the ratio of nonperforming loans to total loans, net of unearned income, increased to 5.90% at March 31, 2003 from 4.06% at December 31, 2002. These changes were primarily due to an increase in nonaccruing loans of \$7,552,000 or 74.8%, to \$17,651,000 at March 31, 2003 from \$10,099,000 at December 31, 2002 and an increase in other real estate of \$827,000, or 10.8%, to \$8,503,000 at March 31, 2003 from \$7,676,000 at December 31, 2002. These increases were partially offset by a decline in loans past due 90 days or more of \$885,000, or 71.3%, to \$356,000 at March 31, 2003 from \$1,241,000 at December 31, 2002. Total nonperforming assets increased \$6,683,000, or 30.0%, to \$28,943,000 at March 31, 2003 from \$22,260,000 at December 31, 2002. The significant increase in nonaccrual loans was mostly due to a \$5,150,000 real estate loan to the Company's former Chairman and Chief Executive Officer who filed bankruptcy in January, 2003. It is the Company's policy to place loans on nonaccrual status when a borrower files bankruptcy.

#### Funding

The Company's primary sources of funding are from deposits from the customers of Community Bank and from other short-term and long-term borrowings. Total deposits of \$461,744,000 at March 31, 2003 reflected an increase of \$2,280,000, or 0.5%, from \$459,464,000 at year-end 2002. Deposits are Community Bank's primary source of funds. Noninterest-bearing deposits increased \$3,946,000, or 7.5%, to \$56,867,000 at March 31, 2003 from \$52,921,000 at December 31, 2002, while interest-bearing deposits decreased \$1,666,000, or 0.4%, to \$404,877,000 at March 31, 2003 from \$406,543,000 at December 31, 2002. Certificates of deposit of \$100,000 or more increased \$13,985,000, or 19.8%, to \$84,612,000 at March 31, 2003 from \$70,627,000 at December 31, 2002.

Total short-term borrowings decreased \$1,523,000, or 88.3%, to \$202,000 at March 31, 2003 from \$1,725,000 at December 31, 2002. FHLB long-term debt remained constant at \$38,000,000 for both March 31, 2003 and December 31, 2002 while other long-term debt decreased \$101,000, or 2.8%, to \$3,477,000 at March 31, 2003 from \$3,578,000 at December 31, 2002.

In March 2000, the Company formed a wholly-owned Delaware statutory business trust, Community (AL) Capital Trust I (the "Trust"), which issued \$10,000,000 of guaranteed preferred securities representing undivided beneficial interests in the assets of the Trust ("Capital Securities"). All of the common securities of the Trust are owned by the Company. The proceeds from the issuance of the Capital Securities (\$10,000,000) and common securities (\$310,000) were used by

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the Trust to purchase \$10,310,000 of junior subordinated deferrable interest debentures of the Company which carry an annual interest rate of 10.875%. Under the terms of the indenture, the Company may elect to defer payments of interest for up to ten semiannual payment periods. The Company has elected to defer its March 2002, September 2002 and March 2003 interest payments and may elect to do so again based on the liquidity needs of the Company when future payments become due. For the duration of such deferral period, the Company is restricted from paying dividends to shareholders or paying debt that is junior to the debenture. The debentures represent the sole asset of the Trust. The debentures and related income statement effects are eliminated in the Company's consolidated financial statements. The Company is entitled to treat the aggregate liquidation amount of the debentures as Tier I capital under Federal Reserve guidelines.

18

The Capital Securities accrue and pay distributions semiannually at a rate of 10.875% per annum of the stated liquidation value of \$1,000 per capital security. The Company has entered into an agreement which fully and unconditionally guarantees payment of: (i) accrued and unpaid distributions required to be paid on the Capital Securities; (ii) the redemption price with respect to any Capital Securities called for redemption by the Trust; and (iii) payments due upon a voluntary or involuntary liquidation, winding up or termination of the Trust.

The Capital Securities are mandatorily redeemable upon the maturity of the debentures on March 8, 2030, or upon earlier redemption as provided in the indenture pursuant to which the debentures were issued. The Company has the right to redeem the debentures purchased by the Trust: (i) in whole or in part, on or after March 8, 2010; and (ii) in whole (but not in part) at any time within 90 days following the occurrence and during the continuation of a tax event, capital treatment event or investment company event (each as defined in the indenture). As specified in the indenture, if the debentures are redeemed prior to maturity, the redemption price will be a percentage of the principal amount, ranging from 105.438% in 2010 to 100.00% in and after 2020, plus accrued but unpaid interest.

### Liquidity

The following is a discussion of cash flows. The Company experienced an approximate \$14,540,000 increase in cash and cash equivalents during the first three months of 2003. Cash provided by operating activities was \$2,868,000. Investing activities provided an increase of \$11,036,000, mostly from loan payments from customers. Financing activities provided \$636,000 of cash and cash equivalents for the first quarter of 2003. Certificates of deposits decreased \$4,969,000, but was more than offset by increases in cash from the growth of demand deposits, NOW deposits, and other savings deposits totaling \$7,248,000.

Dividends paid by Community Bank are the primary source of funds available to the Company. The Company relies on dividends from Community Bank in order to pay expenses, service debt and pay dividends to shareholders. Certain restrictions exist regarding the ability of Community Bank to transfer funds to the Company in the form of cash dividends, loans or advances. Although dividends from Community Bank are the primary source of funding, the Company also receives cash from its subsidiaries for its portion of tax benefit on intercompany income tax settlements. Community Bank discontinued paying the Company a management fee in 2003. The Company's primary cash outflow is now debt service. Community Bank is unable to pay a dividend to the Company without prior approval of the regulatory authorities. The Company could become unable to service its debt without dividends from Community Bank.

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### Capital Resources

Total shareholders' equity at March 31, 2003 was 6.91% of total assets as compared to 7.10% at December 31, 2002. The decrease experienced during the first three months of 2003 is primarily a result of net losses of \$549,000.

Bank regulatory authorities have issued risk-based capital guidelines that take into consideration risk factors associated with various categories of assets, both on and off the balance sheet. Under the guidelines, capital strength is measured in two tiers, which are used in conjunction with risk-adjusted assets to determine the risk-based capital ratios. The Company's Tier I capital, which includes common stock, retained earnings and guaranteed preferred beneficial interest in the Company's junior subordinate deferrable interest debentures, amounted to \$46,313,000 at March 31, 2003, compared to \$46,817,000 at December 31, 2002. Tier II capital components include supplemental capital components, such as qualifying allowance for loan losses and qualifying subordinated debt. Tier I capital plus the Tier II capital components are referred to as total risk-based capital, which was \$50,828,000 at March 31, 2003 as compared to \$52,897,000 at year-end 2002. The percentage ratios, as calculated under the guidelines, for tier I and total risk-based capital were 13.03% and 14.29%, respectively, at March 31, 2003, compared to 12.95% and 14.63%, respectively, at year-end 2002. At March 31, 2003, both tier I and total risk-based capital of the Company exceeded the regulatory minimum ratios of 4% and 8%, respectively.

18

Another important indicator of capital adequacy in the banking industry is the leverage ratio. The tier I leverage ratio is defined as the ratio that the Company's tier I capital bears to total average assets minus goodwill. The Company's tier I leverage ratios were 8.25% and 8.20% at March 31, 2003 and December 31, 2002, respectively, exceeding the regulatory minimum requirement of 4%.

### RESULTS OF OPERATIONS

Three months ended March 31, 2002 and 2001

#### Summary

The Company's net loss for the three months ended March 31, 2003 was \$549,000, a decrease of \$1,782,000 from net income of \$1,233,000 for the same period in 2002. Both basic and diluted net loss per share was \$0.12 for the three months ended March 31, 2003, as compared to net income per share of \$0.27 for the same period in 2002.

The following discussion is on results of operations from continuing operations of the Company. Refer to Note 6 of the Notes to Consolidated Financial Statements for a description of the presentation for discontinued operations.

#### Net Interest Income

Net interest income, the difference between interest earned on assets and the cost of interest-bearing liabilities, was \$5,077,000 for the three months ended March 31, 2003. Net interest income, before provision for loan losses, decreased \$988,000, or 16.3%, from \$6,065,000 for the same period of 2002. Revenues from interest earning assets of the Company decreased \$1,752,000, or 16.4%, to \$8,914,000 for the three months ended March 31, 2003 from \$10,666,000 for the same period in 2002. This decrease was due to lower yields on and volume of interest earning assets. Average earning assets outstanding during the first quarter of 2003 were \$503,928,000, which represents a decrease of \$37,849,000,

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or 7.0%, from \$541,777,000 for the first quarter of 2002. The Company's yield on its average earning assets decreased 81 basis points to 7.17% for the first three months of 2003, compared to 7.98% for the same period of 2002. This decrease is somewhat reflective of the overall decrease in interest rates experienced during the year 2002. Interest expense for the three months ended March 31, 2003 decreased \$765,000, or 16.6%, to \$3,837,000 from \$4,602,000 for the corresponding period of 2002. This decrease occurred due to a decline in rates paid on and volume of interest-bearing liabilities. Average interest-bearing liabilities during the first quarter of 2003 were \$460,854,000, which represents a decrease of \$7,938,000, or 1.7%, from \$468,792,000 for the same period of 2002. The rate paid on average interest-bearing liabilities decreased 60 basis points to 3.38% for the three month period ended March 31, 2003, compared to 3.98% for the first three months of 2002. This decrease is also attributable to the overall decline in interest rates during the year 2002.

The Company's net interest margin for the three months ended March 31, 2003 decreased 45 basis points to 4.09%, from 4.54% for the three months ended March 31, 2002, due to the decrease in net interest income. Net interest margin is computed by dividing net interest income by average interest earning assets. This ratio represents the difference between the average yield returned on average interest earning assets and the average rate paid on funds used to support those interest earning assets, including both interest-bearing and noninterest-bearing sources.

The Company's net interest spread for the three months ended March 31, 2003 decreased 21 basis points to 3.79%, from 4.00% for the three months ended March 31, 2002, as the average cost of interest-bearing sources of funds decreased 60 basis points while the average yield on interest earning assets decreased 81 basis points. Net interest spread measures the difference between the average yield on interest earning assets and the average rate paid on interest-bearing sources of funds.

19

### Provision for Loan Losses and Allowance for Loan Losses

At March 31, 2003, the allowance for loan losses was \$10,123,000 which represented an increase of \$339,000, or 3.5%, from the December 31, 2002 amount of \$9,784,000. The provision for loan losses was \$1,289,000 and \$944,000 for the three months ended March 31, 2003 and 2002, respectively. The increase resulted from management's decision to make provisions for current losses in the loan portfolio as it continues its effort to improve the overall credit quality of the Company. In this effort, management has increased the allowance for loan losses account as a percent of loans to reserve for potential losses in the loan portfolio by recognizing additional provisions for loan loss expense. As a percentage of total loans, net of unearned income, the allowance for loan losses increased to 2.92% at March 31, 2003, compared to 2.72% at December 31, 2002. Loan charge-offs exceeded recoveries by \$950,000 during the first three months of 2003, which represented an increase of \$96,000, or 11.2%, from \$854,000 for the same period during 2002. Management believes that the allowance for loan losses at March 31, 2003 is adequate; however, no assurance can be given that additional losses may not occur or that additional provisions to the allowance for loan losses will not be necessary.

### Noninterest Income

Noninterest income for the three months ended March 31, 2003 increased \$474,000, or 27.7%, to \$2,184,000, from \$1,710,000 for the same period of 2002. Service charges on deposit accounts decreased \$151,000, or 19.8%, to \$611,000 for the first quarter of 2003 from \$762,000 in the first quarter of 2002. Debt

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cancellation fees decreased during the first quarter of 2003, as compared to the first quarter of 2002, \$30,000, or 50.0%, due to decreased volume in debt cancellation coverage associated with the decline in the Company's loan portfolio. Other operating income remained stable at \$226,000. The Company recorded net gains on the sale of investment securities of \$648,000 during the three months ended March 31, 2003, compared to net gains on the sale of investment securities of \$17,000 for the same period of 2002. The net securities gains were the primary reason for the increase in noninterest income, although the Company also experienced a 4.4%, or \$24,000 increase in insurance commissions attributable to increased revenues from the Company's subsidiary, Community Insurance Corp.

### Noninterest Expenses

Noninterest expenses for the three months ended March 31, 2003 were \$7,009,000, representing a \$277,000, or 4.1%, increase from \$6,732,000 for the same period of 2002. The primary components of noninterest expenses are salaries and employee benefits, which decreased \$145,000, or 4.2%, to \$3,329,000 for the three months ended March 31, 2003 from \$3,474,000 for the same period of 2002. Occupancy costs decreased \$2,000, or 0.3%, to \$589,000 for the first quarter of 2003 from \$591,000 for the same period of 2002. Furniture and equipment expenses for the three month periods ended March 31, 2003 decreased \$39,000, or 9.6%, to \$367,000 from \$406,000 for the same period of 2002. Director and committee fees increased \$25,000, or 25.8%, to \$122,000 for the first quarter of 2003 from \$97,000 for the first quarter of 2002. This increase is the result of increased Board meetings due to the many changes the Company has experienced during the first quarter of 2003. Other operating expenses were \$2,349,000 and \$1,769,000 for the three month periods ended March 31, 2003 and 2002, respectively. This increase of \$580,000, or 32.8%, was primarily due to increased expenses, especially legal fees, related to the continued litigation against the Company and even more so related to the agreement with the Alabama State Banking Department and the investigation into payments made in connection with construction projects of the Bank.

### Income Taxes

The Company attempts to maximize its net income through active tax planning. Tax benefits were \$487,000 for the three month period ended March 31, 2003 compared to tax expense of \$614,000 for the same period in 2002.

20

## Item 3 - Quantitative and Qualitative Disclosures About Market Risk

### Interest Rate Sensitivity

Community Bank's net interest income, and the fair value of its financial instruments, are influenced by changes in the level of interest rates. Community Bank manages its exposure to fluctuations in interest rates through policies established by its Asset/Liability Committee ("ALCO"). The ALCO meets periodically to monitor its interest rate risk exposure and implement strategies that might improve its balance sheet positioning and/or earnings. Management utilizes an Interest Rate Simulation model to estimate the sensitivity of the Bank's net interest income and net income to changes in interest rates. Such estimates are based upon a number of assumptions for each scenario, including balance sheet growth, deposit repricing characteristics and prepayment rates.

The estimated impact on Community Bank's net interest income sensitivity over a one year time horizon at March 31, 2003 is shown below. Such analysis assumes an immediate and nonparallel shift in interest rates and the Bank's estimates of how interest-bearing transaction accounts will reprice.

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## RATE SHOCK ANALYSIS

	-100 Basis Points	Level (Dollars in thou)
Prime Rate.....	3.25%	4.25%
Interest Income.....	\$ 32,868	\$ 34,501
Interest Expense.....	11,698	12,674
	-----	-----
Net Interest Income.....	\$ 21,170	\$ 21,827
	=====	=====
Dollar change from Level.....	\$ (657)	
Percentage change from Level.....	(3.01)%	

As shown above, in a 100 basis point rising rate environment, the net interest margin is projected to increase 0.40% and in a 100 basis point falling rate environment, the net interest margin is projected to decrease 3.01%. These percent changes from a level rate scenario fall comfortably within Community Bank's ALCO policy limit of +/-7.00%.

21

### Item 4 - Controls and Procedures

#### (a) Evaluation of disclosure controls and procedures.

The Company has evaluated the effectiveness of its disclosure controls and procedures pursuant to Securities Exchange Act Rule 13a-14. The evaluation was performed under the supervision and with the participation of management, including the chief executive officer and the chief financial officer, within 90 days prior to the date of the filing of this annual report. Based on this evaluation, the chief executive officer and chief financial officer have concluded that the disclosure controls and procedures are effective in ensuring that all material information required to be disclosed in this annual report has been communicated to them in a manner appropriate to allow timely decisions regarding required disclosure.

#### (b) Changes in internal controls.

Subsequent to the date of their evaluation, there were no significant changes in internal controls or other factors that could significantly affect internal controls, including any corrective actions with regard to significant deficiencies and material weaknesses.

22

## PART II OTHER INFORMATION

### Item 1 - Legal Proceedings

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On or about April 21, 2003 the plaintiffs in the lawsuit styled Benson et al v. Community Bancshares, Inc. et al. filed a motion to enforce the tentative settlement announced in November, 2002.

On May 5, 2003 two former executive officers of the Company and Community Bank filed separate suits in the Circuit Court of Blount County, Alabama, against the Company, Community Bank, Kennon R. Patterson, Sr., former Chairman and Chief Executive Officer of the Company and Community Bank, and a number of fictitious defendants. Bishop K. Walker, Jr., former Senior Executive Vice President and General Counsel of the Company, and Denny G. Kelly, former President of Community Bank, allege that they were induced to retire based on misrepresentations made by Kennon R. Patterson, Sr. who was allegedly acting within the scope of his duties as an agent of the Company and Community Bank. Plaintiffs claim that these actions constituted fraud, promissory fraud, fraudulent suppression, fraud in the inducement, deceit, fraudulent deceit, negligence, recklessness, wantonness and breach of contract. The complaints ask for an unspecified amount of compensatory and punitive damages. Although management currently believes that this action will not have a material adverse effect on the Company's financial condition or results of operations, regardless of the outcome, the action could be costly, time consuming and a diversion of management's attention.

On May 8, 2003 the Company, Community Bank and most of the individual defendants filed a motion to transfer the lawsuit styled Packard et al. v. Sheffield Electrical Contractors, Inc. et al. from the Circuit Court of Jefferson County, Alabama, to the Circuit Court of Blount County, Alabama, or, in the alternative, to dismiss the suit.

On May 9, 2003 the defendants in the lawsuit styled Patterson v. Community Bancshares, Inc. et al. filed a motion to dismiss the suit.

Except as noted above, no reportable events or material developments have occurred since the filing of the Company's Annual Report on Form 10-K (the "Form 10-K"), for the year ended December 31, 2002 and filed on April 15, 2003. In connection with the settlement of the lawsuit brought by Michael Alred and Michael Bean against Community Bank, as disclosed in the Form 10-K, Messrs. Alred and Bean were dismissed as defendants in the lawsuit styled Community Bancshares, Inc. et al. v. Corr et al.

### Item 6 - Exhibits and Reports on Form 8-K

#### (a) Exhibits

11 Statement of computation of per share earnings

99.1 Chief Executive Officer - Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

99.2 Chief Financial Officer - Certification pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002.

#### (b) Reports on Form 8-K

January 27, 2003 - Disclosure of Patrick Frawley replacing Kennon Patterson as Chairman, CEO and President of Community Bancshares.

January 23, 2003 - Disclosure of Kennon R. Patterson, Sr.'s filing for protection under Chapter 11 of the U.S. Bankruptcy code.

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February 8, 2003 - Disclosure of removal of Kennon R. Patterson, Sr. and Kennon R. Patterson, Jr. from the Community Bank Board of Directors and appointment of Stacey Mann as Acting President of Community Bank.

March 4, 2003 - Disclosure of the stipulation and consent to the issuance of an order to cease and desist with the Federal Deposit Insurance Corporation.

24

### SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned, hereunto duly authorized, in the city of Blountsville, State of Alabama, on May 15, 2003.

COMMUNITY BANCSHARES, INC.

By: /s/ Patrick M. Frawley

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Patrick M. Frawley  
Chairman, Chief Executive Officer, and President

By: /s/ Kerri C. Kinney

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Kerri C. Kinney  
Chief Financial Officer

25

### CERTIFICATIONS

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I, Patrick M. Frawley, certify that:

1. I have reviewed this quarterly report on Form 10-Q of Community Bancshares, Inc.;
2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash flows of the registrant as of, and for, the periods presented in this quarterly report;
4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those



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entities, particularly during the period in which this quarterly report is being prepared;

- b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
- a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

By: /s/ Patrick M. Frawley

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Patrick M. Frawley  
Chairman, Chief Executive Officer and  
President

May 15, 2003

26

### CERTIFICATIONS

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I, Kerri C. Kinney, certify that:

- 1. I have reviewed this quarterly report on Form 10-Q of Community Bancshares, Inc.;
- 2. Based on my knowledge, this quarterly report does not contain any untrue statement of a material fact or omit to state a material fact necessary to make the statements made, in light of the circumstances under which such statements were made, not misleading with respect to the period covered by this quarterly report;
- 3. Based on my knowledge, the financial statements, and other financial information included in this quarterly report, fairly present in all material respects the financial condition, results of operations and cash

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flows of the registrant as of, and for, the periods presented in this quarterly report;

4. The registrant's other certifying officers and I are responsible for establishing and maintaining disclosure controls and procedures (as defined in Exchange Act Rules 13a-14 and 15d-14) for the registrant and we have:
  - a) designed such disclosure controls and procedures to ensure that material information relating to the registrant, including its consolidated subsidiaries, is made known to us by others within those entities, particularly during the period in which this quarterly report is being prepared;
  - b) evaluated the effectiveness of the registrant's disclosure controls and procedures as of a date within 90 days prior to the filing date of this quarterly report (the "Evaluation Date"); and
  - c) presented in this quarterly report our conclusions about the effectiveness of the disclosure controls and procedures based on our evaluation as of the Evaluation Date;
5. The registrant's other certifying officers and I have disclosed, based on our most recent evaluation, to the registrant's auditors and the audit committee of registrant's board of directors (or persons performing the equivalent function):
  - a) all significant deficiencies in the design or operation of internal controls which could adversely affect the registrant's ability to record, process, summarize and report financial data and have identified for the registrant's auditors any material weaknesses in internal controls; and
  - b) any fraud, whether or not material, that involves management or other employees who have a significant role in the registrant's internal controls; and
6. The registrant's other certifying officers and I have indicated in this quarterly report whether there were significant changes in internal controls or in other factors that could significantly affect internal controls subsequent to the date of our most recent evaluation, including any corrective actions with regard to significant deficiencies and material weaknesses.

By: /s/ Kerri C. Kinney

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Kerri C. Kinney  
Chief Financial Officer

May 15, 2003

Exhibit 11 - Statements Re: Computation of Per Share Earnings

Community Bancshares, Inc.  
Computation of Net Income (Loss) per Common Share

The following tabulation presents the calculation of basic and fully diluted earnings per common share for the three months ended March 31, 2003 and 2002.

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	For the Three Mo
	-----
	2003
	-----
Reported income (loss) from continuing operations.....	\$ (549,109)
	=====
Reported income from discontinued operations.....	\$ -
	=====
Earnings (losses) on common shares.....	\$ (549,109)
	=====
Weighted average common shares outstanding - basic.....	4,640,527
	=====
Earnings per common share - basic	
Income (loss) from continuing operations.....	\$ (0.12)
	=====
Income from discontinued operations.....	\$ -
	=====
Net income (loss).....	\$ (0.12)
	=====
Weighted average common shares outstanding - diluted.....	4,640,527
	=====
Earnings per common share - diluted	
Income (loss) from continuing operations.....	\$ (0.12)
	=====
Income from discontinued operations.....	\$ -
	=====
Net income (loss).....	\$ (0.12)
	=====

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28

Exhibit 99.1

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with Community Bancshares, Inc. ("Company") Quarterly Report on Form 10-Q for the period ended March 31, 2003 ("Report"), each of the undersigned certify that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

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Date: May 15, 2003  
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By: /s/ Patrick M. Frawley  
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Patrick M. Frawley  
Chairman, Chief Executive Officer and President

29

Exhibit 99.2

CERTIFICATION PURSUANT TO  
18 U.S.C. SECTION 1350  
AS ADOPTED PURSUANT TO  
SECTION 906 OF THE SARBANES-OXLEY ACT OF 2002

In connection with Community Bancshares, Inc. ("Company") Quarterly Report on Form 10-Q for the period ended March 31, 2003 ("Report"), each of the undersigned certify that:

1. The Report fully complies with the requirements of Section 13(a) or 15(d) of the Securities Exchange Act of 1934; and
2. The information contained in the Report fairly presents, in all material respects, the financial condition and results of operations of the Company.

Date: May 15, 2003  
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By: /s/ Kerri C. Kinney  
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Kerri C. Kinney  
Chief Financial Officer

30